IN THE

Supreme Court of the United States

October Term, 1943.

No. ———

HARTFORD-EMPIRE COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

STATEMENT.

Before the Board of Tax Appeals (now Tax Court) and the Court below the two issues in this case were argued in the alternative, namely:

1. Whether petitioner's annual deductions for depreciation or amortization of the Empire and Howard patent rights were finally settled and determined by the prior decision of the Board under the doctrine of res judicata and by the acquiescence of the Commissioner therein for several years thereafter under the theory of estoppel. If not,

2. Whether the Empire and Howard patent rights were acquired by petitioner by purchase rather than as tax free exchanges under Section 112(b)(5) of the Revenue Act.

It was agreed in the stipulation of facts filed below that if either or both of these questions were decided in the affirmative, then the deductions for depreciation or amortization of said patent rights claimed by petitioner in its returns for the years involved are correct and shall be allowed. The action of the Court below in affirming the Board's decision in favor of the respondent on both issues is alleged as error and forms the basis of the foregoing petition for review on Writ of Certiorari. Argument on each issue will be considered separately.

ARGUMENT.

I. Issue Under Section 112(b)(5).

The Court below rested its decision on the merits of this case solely on the payment of the notes and warrants by the issuance of preferred stock to the creditors. Although it agreed that the notes were *paid*, since by their terms they were payable "in cash or preferred stock" of the Fairmont Company "or its successor" (Petitioner herein), nevertheless the Court concluded that the notes were "property * * * transferred * * * in exchange for stock" within the meaning of Section 112(b)(5) of the Revenue of 1932.

Had the Court below applied the clear fundamental reasoning of its own prior decisions, and those of other Circuit Courts of Appeal, following an opinion of this Court (heretofore mentioned in "Reasons for Granting the Writ") the conclusion would have been inescapable that payment of notes or other evidences of indebtedness do not involve the "transfer" or "exchange" of property as applied to the Revenue law.

(1) *Conflict with Supreme Court.*

This Court in *Douglas Fairbanks* v. *United States*, 306 U. S. 436 stated this fundamental rule—

> "Payment and discharge of a bond is neither a sale nor exchange within the commonly accepted meaning of the words",

and held that the Court below rightly applied the "commonly accepted meaning" in the application of the capital gains provisions of the statute.

This Court further stated in *Helvering* v. *William Flaccus Oak Leather Co.*, 313 U. S. 247—

> "* * * 'exchange' * * * implies reciprocal transfers of capital assets, * * *".

(2) *Conflicting Authorities in Court Below.*

The *Fairbanks* case (*supra*) was followed by the Court below in *Bingham* v. *Commissioner* (CCA-2) 105 Fed. (2d) 971; involving a conveyance of property by the debtor to the noteholder in satisfaction and cancellation of the notes. In holding that the transaction involved neither a sale nor exchange of capital assets within the meaning of the statute, but rather an extinguishment of the property right of holder in the notes, the court said—

> "One would not ordinarily speak of the surrender of a note to its maker as the sale of the note to him even though the surrender was for full consideration, as when the amount due on it was paid in cash. Neither would such a transaction in the ordinary course of business be looked upon as an exchange of the note for the amount due on it. The language of a revenue act is to be read in the light of the practical matters with which it deals and *is to be given its ordinary significance in arriving at the meaning of the statute*".

The Court below cited the *Fairbanks* opinion of this Court as authority for its decision in the *Bingham* case. Also see *Yates* v. *McGowan* (D. C. N. Y.), 39 Fed. Supp. 257, affirmed (CCA-2) 126 Fed. (2d) 624, holding on authority of the *Fairbanks* case, that payment of bonds by the maker does not involve a transfer of property by the bondholder.

(3) *Conflicting Decisions of Other Circuits.*

Hale v. *Helvering*, 85 Fed (2d) 819 decided by the Court of Appeals, D. C. was the first case to discuss the question of "payment of notes", and to hold in that connection that the language of Revenue Act is to be taken in its ordinary sense. As to payment of notes that Court stated "There was no acquisition of property by the debtor, no transfer of property to him."

This case was cited and followed by the Second Circuit in the *Bingham* case, by the Third Circuit in *Felin* v. *Kyle*, 102 Fed. (2d) 349; by the Ninth Circuit in the *Fairbanks* case, 95 Fed. (2d) 794 and *Commissioner* v. *Spreckels*, 120 Fed. (2d) 517.

Each of these cases are clearly in conflict with the reasoning of the Court below in the instant case. If a payment of notes or bonds is not a "sale" or "exchange" of a capital asset under one section of the statute, surely there is no "exchange" of property here merely because a different section of the same statute is in question. The requirement of "exchange of property for stock" in Section 112(b)(5) is not met when the property in the notes was extinguished by payment in the common and ordinary sense of the words. The petitioner acquired nothing; it merely paid the obligations it had legally assumed in accordance with the tenor of such obligations.

In *Glenn* v. *Courier-Journal Job Printing Co.*, 127 Fed. (2d) 820 the Sixth Circuit Court of Appeals rejected efforts of the Commissioner of Internal Revenue to bring the facts of that case within the non-taxable exchange provisions of Section 112 by stating (at p. 823)—

> "Appellee made no exchange of its property or stock but rather received property in partial payment for a debt".

(4) *Opinion Below is Contrary to Well Established Principles of Law and Unsettles an Important Question Under the Federal Revenue Laws.*

This is a case of first impression, in that there are no cases decided by any of the Circuit Courts or this Court directly in point. We are not unmindful of the fact that the *Fairbanks case, the Bingham, Hale, Felin* and *Spreckels* cases did not involve stock of a corporation issued in payment of notes nor was Section 112(b)(5) involved therein, but the rationale of those decisions are clearly pertinent. On the other hand cases which have held Section 112(b)(5) applicable have involved the situation where the debtor corporation has become insolvent and the creditors although exchanging their notes or bonds for stock in a new corporation, have in effect exchanged their equitable interest in the insolvent corporation's assets for such stock, within the purview of Section 112(b)(5). *Helvering* v. *Cement Investors, Inc.*, 316 U. S. 527, *Reed* v. *Commissioner* (CCA-4th), 129 Fed. (2d) 906; *Miller & Paine* v. *Commissioner*, 37 B. T. A. 252; *Rockford Brick & Tile Co.* v. *Commissioner*, 31 B. T. A. 537.

That is not the situation in the instant case: the Fairmont Company was not insolvent; consequently its creditors had no equitable interest in its assets. When Fairmont's assets were transferred to the petitioner, it was a healthy, going concern. Like many another solvent company it had some indebtedness outstanding at the time of transfer. Petitioner, as its successor, merely assumed and paid those debts as a part of the bargain. No case has been found (other than the opinion below) holding that in such a situation creditors of a solvent company have exchanged "property" for stock within the meaning of Section 112(b)(5).

As a matter of fact in a somewhat similar situation the Tax Court in *Bunker Hill & Sullivan Mining Co.* v. *Commissioner*, I. T. C. 1057 denied the applicability of the rationale of the *Cement Investors* case and stated:

> "Furthermore, we are here convinced that the transaction whereby Treadwell Yukon transferred the stock of the new corporation to petitioner in satisfaction of

its indebtedness was simply a payment by the debtor of its own debts. Treadwell Yukon received nothing, *Hale* v. *Helvering*, 85 Fed. (2) 819; *Bingham* v. *Commissioner*, 105 Fed. (2d) 971; *Commissioner* v. *Spreckels*, 120 Fed. (2d) 517."

See also *Sisto Financial Corporation* v. *Commissioner*, 47 B. T. A. 425 denying under similar facts, the applicability of Section 112(b)(3) and citing the same cases appearing in the above quotation. They are the identical cases upon which we have based our assertion of conflict with the decision below. The *Sisto* case is now on appeal to the Second Circuit. That Court to be consistent with its opinion in the instant case will in all probability perpetuate its fundamental error shown herein unless this case is heard by this Court and the error corrected.

Since the result of the decision below is to unsettle an important question of the Revenue laws, it is respectfully submitted that this Court should grant the Writ of Certiorari and finally determine that creditors whose notes are paid and cancelled by the issuance of stock are not "*Transferors of property*" within the purview of Section 112 (b)(5).

II. Res Adjudicata Issue.

1. The Decision of the Court below decides an important Federal Income tax question contrary to well established principles and authoritative decisions ruling the question.

The opinion below violates well settled principles on the question of res judicata in income tax cases as announced by this Court in *Tait* v. *Western Maryland Railway Company*, 289 U. S. 620. That case involved stipulations and concessions as to facts upon which the earlier judgment was predicated, yet it was held that the earlier judgment was none the less binding for all times on the parties. This Court stated—

"The petitioner may not escape the effect of the earlier judgment as an estoppel by showing an *inadvertent*

> *or erroneous concession* as to the materiality, bearing or significance of the facts, provided, as is the case here, the facts and the question presented on those facts were before the Court when it rendered its judgment." (Italics Supplied.)

This Court stated in *Cromwell* v. *County of Sac.*, 94 U. S. 351,—

> "A prior judgment is conclusive evidence as to all matters in issue and thereby determined, in a subsequent suit upon a different cause of action between the same parties or their privities."

The Board had previously held a prior decision involving an earlier tax year binding on subsequent proceedings involving a subsequent year, although the findings and final determination of the Board in the earlier case were based upon a stipulation of facts filed by the parties. *Arthur Curtis James* v. *Commissioner*, 31 B. T. A. 712.

2. The Decision of the Court below disregarded the full legal force and effect of the Board's findings and final judgment in the prior proceedings.

In the instant case the question of the basis for the Empire and Howard patent rights was clearly put at issue in the pleadings. Petitioner alleged in paragraph 5(o) of its petitions for each of the years involved in the prior case the summary of costs of the acquisitions of those rights as of January 1, 1923, as the "Bases for the computation of the costs of foreign rights sold and of the depreciation of unsold foreign and domestic rights". (R. 250.) Respondent interposed a general denial. Those bases were agreed to by both parties in the stipulation of facts filed with the Board which it adopted as its findings of fact and which it approved by its final judgment pursuant to the Settlement under Rule 50 of its own Regulations.

It is clearly settled that if a matter is raised in issue by pleadings in a prior case and that matter is "*determined*" in the original action, the doctrine of res adjudicata applies

in bar of raising the same point in issue by the same parties in a later action. *Tait* v. *Western Maryland Railway Co.* (*supra*). And this Court has adhered to that doctrine even though the matters, by compromise and settlement, have been entered into a decree by consent of the parties, and were not actually litigated in the prior action. *Nashville, Chattanooga & St. Louis Ry. Co.*, 113 U. S. 261. The doctrine of res judicata is fully applicable to matters embraced within consent decrees. *Rector* v. *Suncrest Lumber Co.* (C. C. A. 4), 52 Fed. (2d) 946; *Warner* v. *Tennessee Products Co.* (C. C. A. 6), 57 Fed. (2d) 642.

That final judgment of the Board was its final determination and that determination included the bases for the Empire and Howard rights fully and finally established thereby. Clearly the Court below erred in holding that such final determination did not include these bases now in question under the well recognized principles of estoppel by judgment as announced by this Court.

III. Equitable Estoppel.

Apart from doctrine of res judicata petitioner advanced the theory of equitable estoppel against the respondent in brief and argument before the Court below but this important feature of the case was totally ignored by that Court in its opinion.

Particular emphasis is placed upon the fact that the respondent entered into the stipulation of facts in the prior proceedings before the Board only after a full and complete investigation of all of the facts and circumstances surrounding the transfers of the several groups of patent rights to the petitioner. Both the petitioner and respondent were equally desirous of determining the question pertaining to depreciation or amortization of the patent rights, not only for the years involved in the proceedings before the Board but for all future time. Being fully cognizant of the fact that such a matter was not subject to change

by future events, but once established would endure for the life of the patents, the parties arrived at what they considered the proper bases for depreciation or amortization thereof by a written stipulation which they presented to the Board for its final adjudication and adjusted the tax liability in accordance with the bases thus established for the years involved before the Board.

For several years thereafter the respondent adhered to the bases thus established by the Boards adjudication but in the year 1932 suddenly changed his mind and for the first time raised an issue involving his then interpretation of the highly technical "tax free exchange" provision of the statutes.

It is noteworthy that respondent raised this new theory for the purpose of relegating petitioner to the smaller bases of its transferors only at such time when the entire bases for depreciation or amortization of the patent rights under this new theory would have been entirely exhausted. Had that issue been raised by respondent and judicially determined under respondent's present theory when the question first arose years before, such lesser bases would have been annually adjusted so as to have lasted for the life of the patent. Instead, respondent adhered to his original written agreement and the Board's decision entered pursuant thereto for a number of years, thus lulling petitioner into security. By all standards of justice and fair dealing respondent should not now be allowed to change his position at this late date to the petitioner's detriment when petitioner would no longer have any bases for depreciation or amortization deductions under respondent's present theory.

The question whether the Commissioner of Internal Revenue may be equitably estopped from changing a former position to the detriment of a taxpayer has not been definitely determined by this Court or any of the lower courts. Most of the courts have attempted to dodge the question

as was done in the instant case. However, there have been intimations in some opinions that the theory of equitable estoppel may prevail against the Commissioner where his position is founded on inequity and is inconsistent with a former position to the detriment of a taxpayer.

The Board of Tax Appeals in a memorandum opinion decided July 10, 1939, in *Estate of James Amm,* Docket No. 93476, reported in C. C. H. Board of Tax Appeal Decisions, 10,780-C, held definitely that the Commissioner could be estopped. Here equitable estoppel was invoked when the Commissioner took the position that a trust was invalid and therefore includable in the gross estate for tax purposes where in a former income tax proceeding against the trust he had up-held the validity of the trust. In that opinion the Board remarked—

> "* * * the fact fixed for one year ought to remain fixed in all its consequences so that a party cannot 'blow hot and cold' as suits his interest in tax matters. These principles work against the government as well as against the taxpayer." Citing *Alamo National Bank* v. *Commissioner*, 95 F. (2d) 622; *Balkan National Insurance Co.* v. *Commissioner*, 101 F. (2d) 75.

In *Alamo National Bank* v. *Commissioner* (*supra*), it was stated "in income taxation what is done in one tax year is sometimes projected into another where the same facts must govern. There being continuity, there ought to be consistency in treatment".

Although this latter case did not involve estoppel of the Commissioner it intimated that such a rule would work against him also.

Other departments of government have been held to their written word with members of the public such as in consent decrees in anti-trust cases agreed to by the Attorney General, *U. S.* v. *Radio Corporation of America*, 46 Fed. Supp. 654, and in government contracts, *U. S.* v. *Bethlehem Steel Corporation*, 315 U. S. 289.

The question whether the Commissioner of Internal Revenue may be barred from an attempt to relitigate an issue long since finally determined and adhered to by him is an important Federal tax question which this Court should finally settle. It is therefore respectfully submitted that apart from any other considerations herein the Writ of Certiorari should be granted for the determination of this question.

CONCLUSION.

This Court should grant the Writ of Certiorari to review the decision of the Court below on all issues herein.

Respectfully submitted,

EDGAR J. GOODRICH,
WALTER J. BROBYN,
716 Investment Building,
Washington 5, D. C.,
Counsel for Petitioner.